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Union Calendar 444

99th Congress, 2d Session - - - - - - - - - - - - House Report 99-744

IMPLEMENTING THE FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT—THREE YEARS LATER

FORTY-SECOND REPORT

BY THE

COMMITTEE ON GOVERNMENT OPERATIONS

ORIGINAL

AUGUST 5, 1986.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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U.S. GOVERNMENT PRINTING OFFICE

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LETTER OF TRANSMITTAL

HOUSE OF REPRESENTATIVES,
Washington, DC, August 5, 1986.

Hon. THOMAS P. O'NEILL, Jr.,
Speaker of the House of Representatives,
Washington, DC.

DEAR MR. SPEAKER: By direction of the Committee on Government Operations, I submit herewith the committee's forty-second report to the 99th Congress. The committee's report is based on a study made by its Legislation and National Security Subcommittee.

JACK BROOKS, *Chairman.*

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99TH CONGRESS *2d Session* | HOUSE OF REPRESENTATIVES | REPORT 99-744

IMPLEMENTING THE FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT—THREE YEARS LATER

AUGUST 5, 1986.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. BROOKS, from the Committee on Government Operations, submitted the following

FORTY-SECOND REPORT

BASED ON A STUDY BY THE LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE

On August 5, 1986, the Committee on Government Operations approved and adopted a reported entitled "Implementing the Federal Managers' Financial Integrity Act—Three Years Later." The chairman was directed to transmit a copy to the Speaker of the House.

I. SUMMARY

The Federal Managers' Financial Integrity Act was passed in 1982 to provide a means for strengthening the Federal Government's procedures for maintaining accounting systems and internal controls for its resources. The Act requires Federal managers for the first time to establish a continuous process for evaluating, improving, and reporting on the internal control and accounting systems for which they are responsible. The term "internal controls" as used in the Act is synonymous with "management controls" and includes program and administrative areas as well as accounting and financial management areas.

Various policies and procedures are now in place for accomplishing required evaluations, assessments, and corrective actions to implement the Integrity Act, and agencies have provided training programs to educate managers in their Integrity Act responsibilities. However, much work remains to be done to fully implement the Act. More emphasis needs to be placed on correcting major material weaknesses discovered as a result of the Integrity Act proc-

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ess, as well as previously known weaknesses. Further, improvements are needed in the scope and depth of evaluations performed. Moreover, greater clarity and uniformity are needed among agencies, the Office of Management and Budget (OMB) and the General Accounting Office (GAO) on basic terms such as reasonable assurance and material weakness used in the Integrity Act process. Until agencies are clear on what these terms mean, there will be confusion, inadequate reporting, and impaired implementation of the Act.

The full and informed commitment of managers to the implementation of the Act remains the vital key to its ultimate success. Some managers have generally performed well thus far. There are indications, however, that the paperwork involved in the process at some agencies and the confusion over some of the terms and concepts may be discouraging managers from providing the full commitment and energy required to improve the internal controls for which they are responsible. Agencies are now embarking on efforts to streamline the Integrity Act process, to make it less paperwork intensive, in an effort to accomplish the same good results with less effort. Undoubtedly the experience gained thus far in implementing the Act will be useful in modifying and improving the processes used to initiate implementation. Care must be taken, however, to assure that the streamlining does not reduce or eliminate the necessary rigorous evaluations and assessments of internal and accounting controls.

OMB, GAO, and agency inspectors general have provided considerable guidance, oversight, and technical assistance in getting the Act implemented to date. All participants must continue to build on the work done thus far so that the goals and objectives of the Act can become an institutionalized part of the way an agency conducts its daily tasks. The benefits of the Act are, and will continue to be, better management of Federal resources.

II. Introduction

Federal managers have now had over three full years to implement the requirements of the Federal Managers' Financial Integrity Act. The Act was signed into law on September 8, 1982, following disclosures that weak internal control and accounting systems often lead to fraud, waste and abuse. The Act places primary implementing responsibility on Federal managers, but it also mandates specific actions by the Office of Management and Budget (OMB) and the General Accounting Office (GAO).

The first year's implementation efforts were basically a learning experience in which all participants gained familiarity with the concepts and intention of the Act. Agency efforts to implement the Act and ways in which that implementation needed improving were discussed in a subcommittee report issued in August 1984 entitled "First-Year Implementation of the Federal Managers' Financial Integrity Act." The report noted that progress had been made in the first year in getting implementation started, but that much work on the part of Federal managers remained if the Act was to be fully successful.

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In the second year, agencies were actively pursuing the requirements of the Act in terms of conducting vulnerability assessments, making internal control reviews, identifying material and nonmaterial weaknesses, and taking corrective action on some weaknesses. During this period it became clear that agencies were making a heavy investment in resources to implement the Act. It was also clear that agencies were reporting they had "reasonable assurance" before an adequate assessment of their systems and required testing was completed. During the third year, agencies continued evaluating their management and financial systems while looking for ways to cut back on the considerable amount of paperwork that had become associated with the implementation process.

In order to review the status of the Act's implementation after 3 years, the Legislation and National Security Subcommittee held a hearing on June 4, 1986. Appearing before the subcommittee were John Kasich, Member of Congress, 12th District of Ohio; Charles A. Bowsher, Comptroller General of the United States, U.S. General Accounting Office (GAO); Joseph R. Wright, Jr., Deputy Director, Office of Management and Budget (OMB); and Gerald R. Riso, Assistant Secretary for Policy, Budget and Administration, Department of the Interior.

This report describes the status of the Integrity Act's implementation to date and provides recommendations for improvements that are needed. Appendixes 2 through 9 provide additional information that may be useful to persons with responsibility for implementing the Act. This information is for reference purposes only and is not necessarily endorsed by the committee.

III. The Federal Managers' Financial Integrity Act

A. BACKGROUND

The Federal Managers' Financial Integrity Act of 1982 (see Appendix 1) requires the head of each executive agency to establish a continuous process for the evaluation and improvement of the internal control systems for which he or she is responsible and to report annually to the President and the Congress on the status of the agency's internal control and accounting systems. The Act establishes requirements for agency internal control systems (Section 2) and accounting systems (Section 4).

Section 2 requires that agency internal control systems be evaluated to determine if they meet three objectives:

Obligations and costs are in compliance with applicable law;

Funds, properties, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and

Revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets.

Section 4 requires agency heads to provide annual statements on whether their accounting systems conform to the Comptroller General's Accounting Principles and Standards.

In accordance with the Act, OMB and GAO have provided guidance for agencies' use in implementing the Act. The Comptroller

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General issued "Standards for Internal Controls in the Federal Government" in June 1983. OMB issued "Guidelines for Evaluation and Improvement of and Reporting on Internal Control Systems in the Federal Government" in January 1983, and "Financial Management and Accounting Objectives" in 1985. OMB has also issued Circular A-123 on Internal Controls, which is currently being revised.

Federal agencies have reported under the Act for three years. After the first and second years, the GAO reviewed and reported on the implementation of the Act. Hearings were held by the Legislation and National Security Subcommittee in May 1984 to review the first year's implementation and a committee report issued in August 1984. Prior to the June 1986 hearing, the GAO surveyed the implementation activities and reports of 23 major agencies. Testimony taken during hearings, the GAO surveys, and information received from the agencies indicate that the same implementation problems evident after the first two years continue to exist today. Furthermore, it appears that agencies are confused and concerned about how to deal with the requirements of the Act. Recommendations of this committee after its review of first-year implementation efforts, which were supported by the GAO, are largely unheeded.

A study issued by the President's Council on Management Improvement (PCMI) in 1985 called for streamlining the Integrity Act process with a goal of reducing paperwork. While the committee strongly supports the elimination of unnecessary paperwork, we caution that the PCMI study should not be interpreted by agencies as justification to drop the disciplined evaluations implied in the Act.

B. RESULTS AFTER THE FIRST YEAR

Following its hearing on the first year's implementation efforts, the committee concluded that while the first year's efforts were basically a learning experience for all parties, good initial progress had been made. Many material weaknesses had been identified, though some were longstanding problems. Some problems which surfaced included the failure to include all agency operations in the assessment process, the failure to ensure adequate evaluation and documentation, the failure to train managers properly, and the failure to evaluate adequately controls over ADP and accounting systems. In assessing progress agencies made in implementing the Act at the end of the first year, the committee determined that successful implementation of the Act is dependent on the commitment of managers throughout the Federal Government.[1]

C. RESULTS AFTER THE SECOND YEAR

The GAO assessed the results of implementing the Act at the end of the second year and concluded that the Government continues to face serious internal control and accounting problems. Agen-

[1] "First-Year Implementation of the Federal Managers' Financial Integrity Act," Forty-Third Report of the House Committee on Government Operations, H. Rept. 98-937, 98th Congress, 2d Session, Aug. 2, 1984.

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cies generally identified their problems, but their annual reports to the President and the Congress did not always provide an accurate, clear assessment of the overall status of their systems. Agencies' programs to evaluate their systems improved during 1984, but needed more work in the areas of taking corrective actions and identifying all material weaknesses. About 53 percent of Federal accounting systems were found not to comply with the Comptroller General's standards, resulting in billions of dollars not being adequately accounted for, managed, or financially controlled. Eight categories of material weaknesses were defined as follows:

Financial management and accounting systems;
Procurement;
Property management;
Cash management;
Grant, loan, and debt collection management;
Automated data processing;
Personnel and organizational management; and
Eligibility and entitlement determinations.

Agencies reported at the end of 1984 that thousands of weaknesses, less serious in nature, had been identified and corrected. However, progress to correct serious, longstanding problems was markedly slow.

At the end of 1984, 12 agencies, representing an estimated 55 percent of the Federal budget in FY 1985, stated they had reasonable assurance, taken as a whole, that their agencies' systems met the requirements of the Act, in spite of serious problems identified in their reports. GAO took exception to all 12 of these agency statements because the agencies had not yet developed adequate evaluation programs to assess their internal control systems and because serious uncorrected internal control weaknesses remained. GAO noted that agencies needed to improve their evaluations by increasing system testing, reviewing ADP controls, reevaluating their approaches in assessing internal control systems, and eliminating the paperwork burden associated with system evaluation.

The need was reiterated for OMB to change its reporting guidance to encourage agencies to report having reasonable assurance "except for" systems which they would then identify as not meeting the requirements of the Act—the position taken by this committee in 1984 and supported by the GAO. OMB took a strong stand in favor of agencies continuing to report reasonable assurance "taken as a whole." [2] This controversy over how best to report annually on the results of the assessment was not resolved, continued to affect reporting in 1985, and remains a serious issue for resolution today.

D. STATUS OF CURRENT IMPLEMENTATION

At hearings before the Legislation and National Security Subcommittee on June 4, 1986, Comptroller General Charles A. Bowsher testified on the status of agency implementation of the Act after three years. He noted that agencies had progressed in

[2] GAO Report, "Financial Integrity Act: The Government Faces Serious Internal Control and Accounting Systems Problems," GAO/AFMD-86-14, December 1985.

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". . . identifying and reporting internal control and accounting system weaknesses and their plans for corrective actions . . .," but that they had not progressed well in correcting even those major problems known to the agency when the Act was passed. Likewise, many agency accounting and financial management systems still did not meet standards. In assessing agency efforts to implement the Act in 1985, General Bowsher concluded that the major problems identified in prior years remained.

The Comptroller General pointed out four key factors needing attention if the Act is to be fully and effectively implemented:

Managers must become actively involved in using the Act to help them improve control over Government operations. In addition to evaluating systems, managers must look ahead to potential areas where controls are needed before major breakdowns in controls surface;

Improvements are needed in governmentwide financial management because no overall structure now exists to guide governmentwide financial management improvements;

A sustained commitment of resources is needed to correct the problems identified; and

Continued support from the Congress toward achieving the intent of the Act is needed.

Mr. Joseph R. Wright, Jr., Deputy Director of Office of Management and Budget, testified about progress made to date in implementing the Act. Mr. Wright stated that compliance with the Act had been excellent in a short period of time and that its impact had been widely felt. He cited two concerns affecting implementation. One was the inconsistency in agency reporting of "material weaknesses" in internal controls, and another was the excess paperwork generated in some agencies.

He noted that five of the 23 agencies did not use the term "material weakness"; two others were unable to find any material weaknesses; and one agency reported 385 weaknesses. This happened despite OMB's instruction to use criteria recommended by this committee in its report entitled "First-Year Implementation of the Federal Managers' Financial Integrity Act" (H. Rept. 98–937, August 2, 1984). The criteria are discussed more fully in section IV.B.2. of the report.

The other concern was the paperwork burden that has developed in some agencies. The previously mentioned study by the President's Council on Management Improvement has suggested possible ways to eliminate much of the unnecessary paperwork involved in the implementation process in some agencies. Mr. Wright stated that OMB expected to revise Circular A–123, "Internal Control Systems," to encourage agencies to streamline the Integrity Act implementation process.

1. Ways agencies are improving

With experience gained after several years' implementation efforts together with discussions, training programs, conferences, audits, task force studies, and hearings, agencies are changing their approaches to implementing the Act and building on procedures that seem appropriate for individual agencies. Much of the change is related to the need to reduce self-created administrative

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paperwork burdens. Other changes include institutionalizing the process and developing better techniques for controlling resources. Based on agencies' reports in the last year, some progress has been made to strengthen Integrity Act procedures. For example:

The Department of Defense (DOD) reported that a department-wide tracking system was established in 1985 for monitoring and evaluating program activity and the correction of material weaknesses. Guidelines were issued (1) providing a common basis for preparation of annual assurance statements; (2) establishing criteria for using sources such as inspections, investigations, internal reviews, and audit reports and studies, in addition to internal control reviews, as a means of identifying material weaknesses; and (3) establishing criteria for applying the definition of material weakness. Progress was made in institutionalizing the accounting system certification program within DOD.

The Department of Energy reported expanding ADP evaluations in accordance with OMB Circular A-71, developing and implementing comprehensive ADP internal control guidelines, and increasing its efforts to test accounting systems.

The General Services Administration (GSA) reported an improved system for tracking corrective actions and a new procedure whereby the heads of services and staff offices must brief the agency's Deputy Administrator quarterly on progress regarding corrective actions. Also, in 1985 the Comptroller was designated as responsible for coordinating overall development of GSA's financial management system.

The Department of Health and Human Services reported that it had modified its Integrity Act procedures as of January 1985 and is planning to integrate the requirements of A-123 (Internal Controls), A-127 (Financial Management Systems), and A-130 (Management of Federal Information Resources) into these procedures.

The Department of Housing and Urban Development reported developing a Management Control Plan to identify required actions over the next four years, emphasizing use of internal control reviews and alternative internal control reviews and improving quality control procedures to assure results. Guidance and training for managers is being revised to reflect changes in procedures.

The Small Business Administration (SBA) reportedly has strengthened its Computerized Internal Control Review System to make it more responsive to Circular A-123 and Integrity Act requirements. Since 1984 SBA has published two comprehensive procedural manuals on implementing the Act.

The committee believes that Federal agency heads should make a concerted effort to build on the progress made thus far and to overcome remaining obstacles that prevent full implementation of the Act.

2. Efforts to streamline the process

In October 1985, the President's Council on Management Improvement issued a report titled "Streamlining Internal Control Processes and Strengthening Management Controls With Less Effort," based on a study which analyzed both the paperwork created by the agencies in implementing the Act and ways to reduce generation of that paperwork. The report contains suggestions to

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the agencies. As a result, some agencies are streamlining their Integrity Act procedures along the lines suggested in the report. The study found that substantial time and paper could be saved using alternative internal control reviews (ICR's). It also found that agencies were confused over the implementing guidance issued by OMB and GAO and by the disagreement of OMB and GAO over interpretation of the guidelines and the term "reasonable assurance." The study's recommendations included (1) replacing the vulnerability assessment with a management planning process that emphasized managerial judgment based on specified criteria, (2) the use of alternative ICR's, (3) concentrating audit work on the results rather than process and using the audits as opportunities for commenting on internal control breakdowns, and (4) achieving agreement and/or clarity between OMB and GAO on the implementing guidance.

Mr. Gerald R. Riso, Assistant Secretary—Policy, Budget, and Administration, U.S. Department of the Interior, testified at the subcommittee hearing that part of the problem in implementing the Act was that the language and terminology of the guidance was in the parlance of financial managers, but that the program managers were not familiar with the financial management concepts, such as "internal controls," and techniques for evaluating them. This, according to Mr. Riso, made it appear that the Act was oriented toward financial managers primarily and that the Government was trying to make accountants out of program managers. He indicated that this feeling was supported by the title of the Act, the role of the Comptroller General in the implementation process, and the accounting and auditing language used in the standards, the circular, and the guidelines. Mr. Riso suggested that managers were generally put off by the terminology of the process; the documentation required; the failure to recognize management's judgment in lieu of vulnerability assessments; the emphasis on fraud, waste, and abuse, instead of improved program accomplishments; and utilizing a process that appeared to be outside the manager's normal duties instead of emphasizing the process as being an integral part of his day-to-day activities.

He suggested that the Integrity Act would be more acceptable to managers if agencies (1) held briefings on management control and its importance to senior managers and key staff, and (2) provided agency-specific training material on the Act and its implementation that included participation by GAO and inspector general representatives, (3) increased use of management activities such as management reviews, and (4) recognized that management judgment has a key role in improving controls.

Many of the agencies are modifying their Integrity Act implementation requirements with a view to increasing direct management involvement and reducing the paperwork requirements that they have developed to implement the Act up to now. Examples of these efforts, which have not been analyzed by the committee, include:

The Department of Defense has reduced its documentation requirements and modified its risk assessment process. In 1986, managers will be allowed to rely on prior risk assessments where there have been no changes in the functional area since the last cycle.

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The Department of the Interior has changed its approach to Integrity Act implementation. It is now using a management evaluation plan instead of vulnerability assessments and is emphasizing the use of alternative internal control reviews. The agency requires Bureau Heads and Assistant Secretaries to certify that adequate testing was conducted and to describe the testing. Quality control procedures are required. The agency has included a testing module in the training package.

The Department of Commerce is incorporating internal control reviews with agency management reviews as a means of streamlining its process.

The General Services Administration is instituting a new Management Control Evaluation (MCE) process. In fiscal year 1984 managers used up to 14 different forms and 26 pages of completion instructions. In fiscal year 1985 forms were reduced to five and the number of pages of completion instruction to two. In fiscal years 1983 and 1984, every assessable unit was evaluated. In fiscal years 1985 and 1986 there will be biennial MCE's. Beginning in fiscal year 1987 risk assessments will be done every 4 years.

The Department of Agriculture issued a revised departmental regulation and guide for management controls which were the results of a task force to streamline agency management control processes. The agency reduced the volume of instructions and guidance from 500 to 30 pages, encouraged the use of existing management review procedures, and reduced vulnerability assessment paperwork by 80 percent.

The Environmental Protection Agency has reduced its vulnerability assessments to two pages and emphasized the use of alternative internal control reviews.

[For additional information and guidance on the use of alternative internal control reviews and management evaluation plans, see Appendixes 2 and 3.]

3. Ways in which agencies still need to improve

Agencies still need to improve their performance in correcting material weaknesses in internal controls and in bringing their accounting systems into conformance with the Comptroller General's standards.

Internal control problems continue to be a serious problem in Government operations. Twenty-three agencies reported 314 material internal control weaknesses in 1985. Many of these weaknesses are longstanding problems. For example:

The Department of Defense reported material internal control weaknesses covering a wide range of its operations. Among the problems they reported again in 1985 were weaknesses in its procurement systems through which an estimated $100 billion was spent last year.

The Department of Health and Human Services (HHS) identified 31 departmentwide material internal control weaknesses in 1985. For example, HHS reported weaknesses in a system implemented in January 1984 which accounted for and controlled about $44 billion in 1984 disbursements to states, local governments, schools and nonprofit medical resources activities. GAO pointed out similar weaknesses in the predecessor system. In 1985, HHS reported that

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the current system still does not provide sufficient control of overadvances to recipients. A number of corrections are planned.

The Department of Housing and Urban Development (HUD) reported as material weaknesses longstanding problems in its multibillion dollar housing programs. According to HUD, it is conducting internal control reviews in this area and has established a task force to examine these problems.

Thirteen agencies reported material weaknesses in debt collection. Collectively, these agencies reported having over $199 billion in accounts and loans receivable at the end of fiscal year 1985. Over $20 billion of this was reported as delinquent, representing about 83 percent of the government's delinquent nontax debts.

Agencies also reported weaknesses in ADP operations. The most frequently reported problems pertain to system security.

Weaknesses in accounting and financial management systems continue to be widespread despite the fact that conformity with the Comptroller General principles and standards has been required since passage of the Accounting and Auditing Act of 1950. GAO has found that in 1985, 23 agencies reported 364 accounting systems, of which 160 or 43 precent were reported as not in conformance with the standards. An estimated $683 billion flowed through these accounting systems in 1985. For example:

The Department of Defense reported in 1985 that 81 of its 146 accounting systems did not conform to the Comptroller General's requirements. One area of nonconformance was the absence of adequate general ledger control.

The Social Security Administration made overpayments to beneficiaries of $2 billion in 1984 or 1.1 percent of total outlays of $184 billion. While the agency is successful in recovering 67 percent of overpayments, the total cost including interest cost and collection expenses was over $1.1 billion. GAO and HHS's Inspector General have also reported that SSA's automated accounting systems are vulnerable to fraud.

About $30 billion, representing 46 percent of Education's dollar volume and 35 percent of its total financial transactions in fiscal year 1984, were processed by six accounting systems which the department reported as not conforming to Comptroller General requirements and in need of major upgrade or replacement in 1985.

In both 1984 and 1985, the State Department reported that its accounting systems did not provide adequate control over billions of dollars invested in real and personal property.

IV. Problems Impeding Full Implementation of the Act

In addition to needed improvements in correcting weaknesses identified, conforming accounting systems to standards, and improving ADP management, agencies and OMB need to address factors that still tend to impede the full implementation of the Integrity Act.

A. LACK OF MANAGEMENT COMMITMENT

Managers' performance of their responsibilities under the Act needs to be evaluated; detailed internal control reviews and ac-

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counting system compliance reviews should be completed; and deficiencies identified as a result of these reviews should be corrected.

Some managers have viewed the Integrity Act positively, and have made good progress in implementing it and also in developing excellent guidance and training materials for their agencies. Other managers, however, have not always been positively oriented on the advantages of the Integrity Act to them. They seem to have viewed the Integrity Act processes as an audit function and have not taken an active role in them. Reportedly, the terminology, paperwork, confusion over guidance, and the time and resources required to assure oneself of adequate internal controls have been obstacles. The difference between a positive and a negative outlook is frequently attributed to the degree of commitment found at the top managerial positions in an agency, in both the political and career civil service ranks.

Entities that have reviewed the Integrity Act implementation in addition to this committee have identified management commitment as an important key to making implementation a success. To reach this goal, managers must become accustomed to thinking of their management controls as the "internal controls" referred to in the Act—controls that can be useful to managers in achieving their own objectives.

No amount of after-the-fact auditing or oversight by the inspectors general, GAO, or this committee can compensate for a lack of management commitment. Over the last 3 years, considerable improvement in the degree of management commitment has been observed in some agencies, but much more commitment must be demonstrated before the Act will be fully implemented in most agencies.

Some agencies have begun to provide managers with more training in Integrity Act requirements. The committee believes that good training is essential to assure that managers have a full and consistent understanding of the Act's requirements and the benefits to be achieved by meeting them.

Another important aspect of management commitment is evaluating managers on the performance of their Integrity Act responsibilities. Although not all agencies have taken OMB's advice to rate their managers annually on performing Integrity Act responsibilities, many report that they have done so. Among those who do rate their managers, however, some do not necessarily rate them specifically on fulfilling Integrity Act requirements; rather, they rate their managers on traditional routine performance categories. In addition to providing motivation, rating managers on Integrity Act performance is another way of focusing on the importance of the Act and rewarding performance that is good. The committee believes that specific inclusion of manager's responsibilities under the Act in periodic performance appraisals is essential to maintaining accountability and to assuring the integrity of the process required by the Act.

B. CONTINUING CONFUSION OVER KEY DEFINITIONS AND CONCEPTS

Three years after enactment, there is still confusion and ambiguity over key definitions and concepts in the Act which affect report-

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ing and credibility of the process. The committee believes that complete and consistent understanding of the terms and concepts used in the Act and its implementing guidance is central to achieving necessary improvements in internal controls. Two terms that need further clarification are "reasonable assurance" and "material weakness." Concepts needing further clarification include testing of internal controls and documentation.

1. Reporting on reasonable assurance

Agencies are required to establish and maintain a cost effective system of internal controls to provide reasonable assurance that Government resources are protected and efficiently managed. Reasonable assurance is a judgment on the part of management based on the criteria established by GAO in its "Standards for Internal Controls in the Federal Government." But the level of support needed to assess reasonable assurance remains illusive and always a matter of judgment. One agency has described this term as perhaps the most ill-defined aspect of the internal control program. What is intended is clearly not absolute assurance—this would be cost prohibitive.

In an effort to develop an appropriate basis for their annual statements of reasonable assurance, some agencies are establishing guidelines to identify what work is necessary based on each organizational or functional area and its budget. Better guidance along these lines is needed from OMB in consultation with GAO so that consistent standards can form the basis of statements that reasonable assurance has been achieved. In addition to internal reviews, testing of systems in operation should be a part of the requirement for asserting reasonable assurance. The committee believes that Circular A–123 should include a definition of "reasonable assurance" acceptable to OMB, GAO, and the agencies.

Most agencies cannot, and should not, claim to have reasonable assurance without qualification because of the many material weaknesses at those agencies. The "taken as a whole" formula becomes meaningless when it is known that major material weaknesses exist within agency components including administrative, financial, and program offices. Agencies, however, can have and report reasonable assurance about some systems and not others. Included in the others would be systems that fail to meet testing requirements or which have not yet been tested and examined in detail. It is also important to put both categories of systems in perspective by reporting what amount of outlays of the total annual budget are represented by both categories. This fuller disclosure will put the President and the Congress in the position of knowing how an agency is doing "as a whole." Some agencies are already using this format.

A fair assurance statement might read as follows:

> We believe that we have reasonable assurance that the internal controls and accounting systems in agency components representing "X" percent of total annual outlays meet the requirements of the Act, and that internal controls and accounting systems in agency components representing "Y" percent of annual outlays do not yet meet re-

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quirements and therefore, reasonable assurance cannot be given. The systems not meeting requirements are found in the following agency components: (List the components). In addition, internal controls and accounting systems in agency components representing "Z" percent of total annual outlays have not yet been tested or evaluated. These systems are found in the following agency office components: (List the components).

When agencies are not able to provide reasonable assurance in programs because of material weaknesses, they should include a full description of the corrective actions planned or in-process to address each material weakness as required by the Act.

2. Reporting on material weakness

A "material weakness" can be defined as a situation where internal control procedures do not provide reasonable assurance that the objectives of internal controls specified in the Integrity Act are being accomplished. Agencies are required to report their material weaknesses annually, from all sources, including those arising out of managers' reviews, inspector general audits, GAO audits, and Integrity Act evaluations.

The committee's report, "First-Year Implementation of the Federal Managers' Financial Integrity Act," identified several criteria for determining what constitutes a material weakness. The committee believes that a management deficiency should be considered a material weakness for purposes of reporting under the Act if it could:

Impair fulfillment of an agency's mission,
Deprive the public of needed Government services,
Violate statutory or regulatory requirements, or
Result in a conflict of interest.

GAO has expanded this list to include:

Adverse publicity or embarrassment to the agency which would diminish credibility or reputation, and

A problem that warrants the personal attention or awareness of the agency head or higher management.

The Department of Defense has suggested adding other situations that are potential candidates for material weaknesses, including situations that would:

Endanger national security,
Allow fraud or other criminal activities to go undetected,

Cause loss of control over 5 percent or more of the resources for which an organization is responsible, and

Cause harm, even though minor individually, because they are extensive in the aggregate.

The Department of Transportation includes as a material weakness one that:

Has resulted in actual or alleged fraud over $5,000 traceable to an internal control weakness, or

Is a financial weakness where the result or likely result is the loss or waste of resources amounting to the lesser of $500,000 or 5 percent of the assessable units' resources.

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The Veterans Administration has included any known internal control deficiency which is likely to cause injury or death to any person if not corrected in the near future.

Agencies have struggled with the term "material weakness" and the judgment required to distinguish between a material and a nonmaterial weakness. More effort is needed, however, to understand and use the term correctly and in the manner intended by the Act.

Agencies seem to be reporting only matters which they determine to be significant to the President and the Congress. They are doing this in response to OMB's guidelines which call for a "senior official" to determine whether any of the material weaknesses reported by agency managers warrant reporting to the President and the Congress. This interpretation of the Act is incorrect and has negative consequences for reaching the Act's objectives.

The committee believes that if a problem is significant to a program or individual agency component, it should be considered a major problem for the department or agency, and should be reported. Put another way, under the Act, all material weaknesses are, by definition, matters of interest to the President and the Congress. Reporting all material weaknesses, therefore, is central to the government's ability to effectively manage the resources entrusted to it. The negative effect of allowing a senior official to screen out some material weaknesses is now being discovered by the agency inspectors general and the GAO, who are identifying material weaknesses that should be, but are not being, reported in year-end Integrity Act reports. The role of a senior official in this process should be to advise and consult with agency managers in their identification of material weaknesses, not override their judgment as to what is material.

In addition, GAO has found other reporting problems. For example, some agencies:

Have reported having no material weaknesses when they were known to exist,

Reported only "weaknesses" without distinguishing between material and nonmaterial weaknesses,

Did not report material weaknesses for which corrective actions had been started, and

Failed to follow up by reporting the status of corrective actions on previously reported material weaknesses.

The committee believes that full and clear disclosure of material weaknesses by the agencies is essential to achieve the improved internal controls throughout the executive branch anticipated by the Act. The committee also believes that material weaknesses for which corrective actions were begun, or are in progress, should be included in reports even though those material weaknesses were first identified in a previous report. It would be appropriate in such instances to include the status of corrective actions underway. Material weaknesses included in prior reports for which corrective action has been completed should also be included and the completed action noted.

Agencies have also experienced problems in reporting on the status of their accounting systems. GAO has found that six of 23 agencies it examined for 1985 did not have an adequate basis to

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state that their accounting systems conform to the Comptroller General's requirements, even though they stated they conformed. GAO disagreed with the agencies because they had not yet performed adequate evaluation or testing of their systems to support a statement of general conformance—taken as a whole.

In May 1985, OMB issued accounting system evaluation guidelines. The guidelines provide alternative language to be used if an agency determines that some of its accounting systems conform and others do not. Using this alternative, an agency's report would identify the number of systems that generally conformed and the number that did not conform, and list the material instances of nonconformance. However, the alternative language does not provide for identifying those accounting systems which have not yet been evaluated, nor does it provide for disclosing the significance of systems not in conformance or not yet evaluated.

The committee believes that full disclosure of the status of accounting systems is important to a fair presentation of any agency's status vis-a-vis the Act and that OMB's guidance should require agencies to identify systems that do not conform and systems not yet evaluated and the significance of those systems.

3. Testing of systems in operation

Agencies generally are not adequately testing their systems. Testing is important to determine whether internal controls and accounting systems are operating as designed and are in accordance with established policies and procedures. A system must be tested *in operation* to determine if it is operating as intended.

In trying to streamline the Integrity Act procedures, some agencies are using alternative internal control reviews. It is in the use of these alternative reviews that agencies are likely to weaken their required procedures. The committee would strongly emphasize the need for testing even when alternative internal control reviews are used. Testing internal controls should never be omitted; it is essential to determine the efficacy of the controls. To eliminate any possible confusion concerning testing, OMB guidance should clearly state that testing of systems in operation is required when doing internal control reviews and alternative internal control reviews. Such testing should be reasonable and defensible to third party reviewers. It would be useful for agencies to identify the tests needed in their Management Control Plans. (Appendixes 4, 5, and 6 provide guidance for testing of systems.)

4. Documentation

The term "documentation" has two general meanings in the context of the Act. In one instance, the term is used to describe the process of writing down how a system works. System documentation tells management how its internal control and accounting systems are designed to operate. This allows management to diagnose and correct system breakdowns, particularly in an automated system, and to plan needed improvements. In the second instance, "documentation" refers to recording the steps and results of the Integrity Act assessment process. This provides management with information needed for making determinations about reasonable assurance and about improvements needed in systems assessed. It

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also serves as a record of the work performed and the results obtained.

The committee believes that documentation in both contexts is important and should receive greater attention. Guidance is still needed from OMB on the amount of documentation required to satisfy the Act's requirements. In addition, clarification should be achieved regarding that level of documentation that meets the requirements of the Act, since the level of documentation required may not be the same as auditors would require of themselves in auditing the program under generally accepted government auditing standards. (See appendixes 7, 8, and 9 for additional guidance on documentation.)

V. Conclusions

The Federal Managers' Financial Integrity Act provides needed discipline for Federal managers to improve controls over the Government's resources and thereby increase the American public's confidence in the operation of its Government. That confidence has been eroded over the years by disclosures of fraud, waste, and abuse in Government programs resulting from weak internal controls and accounting systems.

Progress is being made by some agencies in establishing procedures, identifying weaknesses, conducting training programs, developing tracking systems for corrective actions, and streamlining implementation procedures. As a result, many weaknesses in internal controls are being identified, reported, and corrected.

Several important aspects of the Integrity Act implementation, however, are not progressing well and need further attention. Clear definitions of key concepts and terms have not been worked out between OMB, the agencies, and GAO; corrective actions on many material and longstanding weaknesses are not being taken; the reporting guidance is not sufficiently clear with respect to when reasonable assurance can be claimed and what constitutes a material weakness for reporting purposes. Adequate management commitment is not yet evident in all agencies. Efforts to streamline the process need to be closely monitored lest they result in a reduction in the vigor needed to make the Act work successfully. More attention is needed to ADP controls and accounting system evaluations.

OMB and agency managers, in consultation with GAO and the inspectors general, should strive to overcome these remaining impediments to full implementation of the Act. Management throughout the Federal Government must take responsibility for assuring the successful achievement of Integrity Act objectives.

VI. Findings

1. Agencies have not made good progress in taking corrective action on many material weaknesses in internal controls and accounting systems, many of which are longstanding problems.

2. Agencies need to evaluate internal controls and accounting systems more thoroughly so that judgments about their sufficiency with respect to reasonable assurance determinations can be made with greater confidence and credibility.

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3. Basic problems with unclear definitions and reporting requirements and concepts vital to effective implementation of the Act, have not yet been corrected or adequately clarified. As a result, efforts to attain the Act's objectives are impeded.

4. Streamlining procedures may be useful, but care must be taken that established processes that are working well in some agencies not be upset and that the level of rigor required to evaluate controls and correct weaknesses not be reduced.

5. Not all agencies have demonstrated sufficient management commitment to implement the Act successfully.

VII. Recommendations

1. The Office of Management and Budget and the General Accounting Office, in consultation with Federal agencies, should agree on the meaning and use of major terms in the Act, such as reasonable assurance and material weakness, and revise their guidance accordingly.

2. OMB should encourage agency heads to disclose fully the status of their agencies' compliance with the Integrity Act in annual reports by—

Claiming reasonable assurance only for systems where it can be claimed appropriately and listing programs covered by systems that do not meet requirements.

Providing perspective on systems not meeting requirements by showing what percentage of annual outlays those systems represent.

Listing systems that have not yet been evaluated and describing the significance of those systems to overall agency operations, and providing the percentage of annual outlays controlled by these systems.

Describing corrective actions planned, including milestone dates for systems not meeting Integrity Act requirements.

3. Agency heads should assure that all material weaknesses are being identified and the status of corrective actions on these weaknesses is reported in the annual statements.

4. Agency heads should assure that material weaknesses are being addressed by corrective actions, monitored, and corrected in a complete, effective and timely manner.

5. Agency heads should assure that managers are conducting adequate evaluations of internal controls and accounting systems, including testing systems in operation, and that the assessment processes used in reviewing agency systems are documented.

6. Agency heads should assure that agency efforts to streamline the Integrity Act processes are accomplishing a reduction in effort and excess paperwork without sacrificing the effectiveness of the assessment process or circumventing the intent of the Act.

7. GAO and the inspectors general should continue to evaluate Federal managers' efforts to implement the Act, including efforts to streamline the process, and the adequacy of agency actions to correct identified weaknesses.

8. Federal agency heads and agency managers should continue to build on the past years' efforts and reaffirm their commitments to the full and effective implementation of the Act.

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APPENDIXES

[COMMITTEE NOTE.—Appendixes 2 through 9 provide additional information that may be useful to persons with responsibility for implementing the Federal Managers' Financial Integrity Act. However, this information is for reference purposes only and is not necessarily endorsed by the committee.]

APPENDIX 1.—THE FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT OF 1982

An Act To amend the Accounting and Auditing Act of 1950 to require ongoing evaluations and reports on the adequacy of the systems of internal accounting and administrative control of each executive agency, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. This Act may be cited as the "Federal Managers' Financial Integrity Act of 1982".

SEC. 2. Section 113 of the Accounting and Auditing Act of 1950 (31 U.S.C. 66a) is amended by adding at the end thereof the following new subsection:

"(d)(1)(A) To ensure compliance with the requirements of subsection (a)(3) of this section, internal accounting and administrative controls of each executive agency shall be established in accordance with standards prescribed by the Comptroller General, and shall provide reasonable assurances that—

"(i) obligations and costs are in compliance with applicable law;

"(ii) funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and

"(iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets.

"(B) The standards prescribed by the Comptroller General under this paragraph shall include standards to ensure the prompt resolution of all audit findings.

"(2) By December 31, 1982, the Director of the Office of Management and Budget, in consultation with the Comptroller General, shall establish guidelines for the evaluation by agencies of their systems of internal accounting and administrative control to determine such systems' compliance with the requirements of paragraph (1) of this subsection. The Director, in consultation with the Comptroller General, may modify such guidelines from time to time as deemed necessary.

"(3) By December 31, 1983, and by December 31 of each succeeding year, the head of each executive agency shall, on the basis of

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an evaluation conducted in accordance with guidelines prescribed under paragraph (2) of this subsection, prepare a statement—

"(A) that the agency's systems of internal accounting and administrative control fully comply with the requirements of paragraph (1); or

"(B) that such systems do not fully comply with such requirements.

"(4) In the event that the head of an agency prepares a statement described in paragraph (3)(B), the head of such agency shall include with such statement a report in which any material weaknesses in the agency's systems of internal accounting and administrative control are identified and the plans and schedule for correcting any such weakness are described.

"(5) The statements and reports required by this subsection shall be signed by the head of each executive agency and transmitted to the President and the Congress. Such statements and reports shall also be made available to the public, except that, in the case of any such statement or report containing information which is—

"(A) specifically prohibited from disclosure by any provision of law; or

"(B) specifically required by Executive order to be kept secret in the interest of national defense or the conduct of foreign affairs.

such information shall be deleted prior to the report or statement being made available to the public.".

SEC. 3. Section 201 of the Budget and Accounting Act, 1921 (31 U.S.C. 11), is amended by adding at the end thereof the following new subsection:

"(k)(1) The President shall include in the supporting detail accompanying each Budget submitted on or after January 1, 1983, a separate statement, with respect to each department and establishment, of the amounts of appropriations requested by the President for the Office of Inspector General, if any, of each such establishment or department.

"(2) At the request of a committee of the Congress, additional information concerning the amount of appropriations originally requested by any office of Inspector General, shall be submitted to such committee.".

SEC. 4. Section 113(b) of the Accounting and Auditing Act of 1950 (31 U.S.C. 66a(b)), is amended by adding at the end thereof the following new sentence: "Each annual statement prepared pursuant to subsection (d) of this section shall include a separate report on whether the agency's accounting system conforms to the principles, standards, and related requirements prescribed by the Comptroller General under section 112 of this Act.".

Approved September 8, 1982.

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APPENDIX 2.—GUIDANCE FOR USING THE MANAGEMENT EVALUATION PLAN IN LIEU OF A VULNERABILITY ASSESSMENT

(Risk Evaluation Criteria)

(Adapted from the Department of the Interior's Integrity Act guidance for 1986)

Some agencies are substituting a management evaluation plan (MEP) for the traditional vulnerability assessment in an effort to save time and paperwork and to make the best use of existing knowledge about a given program or component to be assessed. Managerial judgment used in the MEP process must be informed judgment, made in a disciplined environment, and should be documented. Risk levels of components are scored in terms of high, medium, or low risk.

The Department of the Interior has established useful criteria to guide managers in exercising judgment when assessing risk. (These criteria are contained in a Department of the Interior memorandum to managers and coordinators from the Director of Financial Management dated January 10, 1986.) Interior has established three levels of criteria as follows: (NOTE.—These criteria are not meant to be all-inclusive. Also, not all evaluation criteria may apply to all agency components.)

A. GENERAL CONTROL ENVIRONMENT

The general control environment consists of management's attitude and discipline concerning internal controls. A low risk control environment would include the following elements:

1. The component is governed by clear, concise, and current legislation and/or regulation and is supported at the bureau level by clear, concise, and current directives.
2. Delegations of authority prevent overlapping, duplication, and conflicts of duties and responsibilities, and divide responsibility so that no single official controls all aspects of a critical transaction.
3. The component has a documented planning process which is integrated with the budgeting system.
4. There are clearly established levels of operational and financial accountability.
5. Prudent and timely action is taken by management on reasonable recommendations from audits and other studies.
6. Correction of previously identified control weaknesses has progressed according to original planned timeframes.

B. INHERENT RISK

Inherent risk is the inherent potential for waste, loss, unauthorized use, or misappropriation due to the nature of an activity itself. Factors increasing the level of inherent risk are:

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1. The component's annual budget (or amount needed to operate the component) or annual collections from the public over $10,000,000.
2. The component has been in existence for less than 2 years, is phasing out, or increasing substantially.
3. The component is federally administered on a largely decentralized basis or is participant administered.
4. The component processes sensitive data and/or records the transfer of funds or assets.
5. The component interacts with other organizational elements and if inadequately controlled, would prevent an organization from achieving its goals.
6. The component involves the protection of tangible assets.
7. Special interest groups affect decisions in this component and/or this component directly affects the public and/or receives special attention from the President, Congress, Secretary, or the media.

C. EXISTING CONTROLS

A preliminary evaluation of existing controls will show if controls in place adequately safeguard the component. Some controls which should be considered are:

1. Is the component supported by a rational and effective organizational structure with appropriate delegations of authority?
2. Are policies and procedures clearly stated in writing and do they provide adequate separation of duties?
3. Is there an active quality review process, e.g., administrative procedures review staff, to assure periodically that internal controls are functioning as intended?
4. Do performance standards for managers assure accountability and require ongoing reviews and improvements?
5. Are appropriate periodic reports used to monitor events and activities?

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APPENDIX 3.—GUIDANCE FOR USE WHEN CONDUCTING ALTERNATIVE INTERNAL CONTROL REVIEWS

[COMMITTEE NOTE.—This information is taken, in part, from the Department of the Interior's training publication entitled "Reviewing Controls With Less Effort," Office of Financial Management, February 24, 1986.]

An alternative internal control review is one that does not follow the full event cycle control review methodology described in the OMB Internal Control Guidelines. Examples of alternative ICR's include modified Circular A-130 reviews, management studies, audits, consultant studies, Circular A-76 studies and computer security reviews. Any alternative review must encompass the GAO internal control standards, must include testing of systems in operation and must be documented. Alternative ICR's make use of existing review processes in reviewing high-risk elements of a component. These reviews are aimed at accomplishing acceptable results with reduced effort and paperwork.

The Department of the Interior is emphasizing the use of alternative ICR's. The agency's guidance portrays the distinction between an ICR and an alternative ICR at Interior. This distinction may be useful information for other agencies as they contemplate the use of alternative ICR's.

ICR's versus alternative ICR's

ICR	*Alternative ICR*
Identify all event cycles	
Identify all risks for each cycle	Identify high risk activities.
Identify control objectives for the risks	
Identify control techniques for the objectives.	Identify controls over high risk activities.
Paper evaluation of control system	
Test internal controls	Limited test of significant controls.
Compare to the GAO control standards.	Compare to the GAO control standards.
Report on results	Report on results.

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APPENDIX 4.—GUIDANCE ON TESTING INTERNAL CONTROLS

[COMMITTEE NOTE.—The guidance below is adapted, in part, from the Department of the Interior's training materials entitled "Reviewing Controls With Less Effort," Office of Financial Management, February 24, 1986.]

The Department of the Interior provides suggestions for testing controls. The following material is adapted from Interior's training materials.

1. Develop a test plan:
   Test controls contributing to control objectives.
   Concentrate testing on controls contributing the most.
   If some controls are not tested, reasons supporting that decision must be provided.
2. Select the method of testing:
   Document analysis—determine if a control is working by reviewing existing records, completed forms, or other documentations.
   Observation—determining if a control is working by watching the performance of a control.
   Interviews—determine if a control works based on information from personnel who perform that control.
   Transaction testing—test ADP operations through the use of dummy transactions.

NOTE.—Testing techniques must be determined based on the nature of the program or component, the risks involved, the type of controls in place, the resources available and the timing of the testing. Also, it is essential that systems be tested in operation to determine if it is operating as intended.

3. Select organizations/locations to be tested:
   Consider the number of locations where the program is executed, locations where principal controls are operational, resources and time available.
   Conduct tests at all principal organizational levels which execute the program using a sampling procedure.
4. Determine how much testing is necessary:
   Tests should not be on 100 percent of the records or 100 percent of the control operation, but on a sample basis.
   The test sample should be representative of the control system and event cycle.
   The sample size should be large enough to allow a conclusion that findings did not happen by chance.
   A larger sample is advisable where:
      Only a small error is acceptable.
      An important resource is at stake.

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Controls to be tested require judgment calls.
There exists an unsupportive attitude toward internal controls.

A smaller sample may be sufficient when:
Controls have worked well in the past.
Risks associated with control failure are not significant.
Controls are routine.
Recent audits or studies have not identified control weaknesses.

Sample selection may vary with the circumstances and include:
Random
Stratified random
Sequential or interval (for example, every 10th occurrence)
Representative (judgmental basis)

5. Plan data collection:
Use tools to simplify, standardize, and document data collection.
The following data collection tools can be used:
Observational log
Frequency tabulation
Work distribution matrix
Checklist
Interview questionnaire

(See Appendix 7 for guidance on data collection tools.)

6. Conduct the tests:
Minimize time required by adequate planning.
Take good notes.
Keep good records of documents reviewed and persons observed or interviewed.
Keep copies of documents or physical evidence to support test results.

7. Document the tests:
It is necessary to document the test performed by keeping working papers or other systematic records.
Use a documentation checklist as a tool for assuring adequate documentation. (See Appendix 10).

8. Analyze test results:
Test results must be analyzed to determine if the degree of compliance is adequate to meet control objectives.
Questions to ask include:
What is the degree of compliance with the control techniques?
Is the degree of compliance adequate? If not, are there additional or compensating controls which meet the control objectives? If so, what are they?
If the techniques are inadequate, what additional techniques are necessary?
Use a documentation tool to record test results and analysis.

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9. Take action on test results:
   Determine which weaknesses are material weaknesses.
   Discuss all weaknesses with appropriate managers.
   Define corrective actions needed.
   Schedule corrective actions including finite completion dates.
   Track corrective actions to completion.
10. Report material weaknesses and corrective actions in annual assurance statements to the President and the Congress.

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APPENDIX 5.—DATA COLLECTION TOOLS

[COMMITTEE NOTE.—The content of this chart is taken from the Department of Health and Human Services' training manual on internal controls entitled "Internal Control Review Guide," February 1986.]

Data collection tool	Explanation	When to use
Observational logs	Brief description of events observed	If you are observing the way in which a control technique is being performed. Or if you are observing in order to spot informal controls used that you may not be aware of.
Frequency tabulations	A count of the number of times an event happens.	If you are observing the number of times a control technique is used.
Work distribution matrix	A matrix used to record tasks performed by a group of employees.	If you are observing or recording separation of duties.
Checklist	A form used to inklicate a condition such as the completion of a step, the achievement of a standard, the existence of required information, etc.	If you are observing the performance of a control technique or reviewing documents resulting from a control technique.
Interview questionnaire	A form used to record the answers to interview questions.	If you are interviewing performers of control techniques.

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APPENDIX 6.—FACTORS FOR SYSTEM TESTING

[COMMITTEE NOTE.—The General Accounting Office has provided this guidance on system testing in its report entitled "Financial Integrity Act: The Government Faces Serious Internal Control and Accounting System Problems," GAO/AFMD–86–14, December 1985.]

System tests should cover the major types of transactions or events a system is designed to process and the key internal controls in a system to ensure that they are operating as intended. Tests should be designed to disclose whether valid transactions or events are processed properly and whether the system rejects those that are invalid.

Testing requires an initial investment of agency resources. However, once a system has been adequately tested and the results documented, fewer resources should be required to reevaluate the system in the future. The reason is that in developing test plans consideration should be given to the results of any prior system testing.

There are a number of techniques that can be used to test system operations, including:

Interviewing persons who operate the systems,

Observing operating procedures,

Examining system documentation,

Determining if control techniques are effective using actual transactions,

Direct testing of computer-based systems by use of simulated transactions, and

Reviewing error reports and evaluating error followup procedures.

In determining which tests would be appropriate for a system, it is important to keep in mind that in most cases, using transaction-testing as the key, more than one of the above techniques are needed to test key aspects of a system. For example, to determine if grants awards are being properly made, an agency could (1) interview persons who operate the system, (2) examine agency policies and procedures (system documentation) to identify control objections and techniques, (3) observe the processing of grant applications through the system, and (4) trace a sample of actual applications through the system to ensure control techniques work and that improper awards have not been made.

Control and risk evaluation calls for the following test procedures:

Preparing a system test plan that (1) specifies system control objectives and system control techniques, (2) describes test objectives, scope, and impact on normal system operations, and (3) lists system transaction or event types, error conditions and input procedures to be tested, and master files to be created and used,

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Testing manual processes,
Testing automated processes,
Analyzing test results, and
Considering costs and benefits.

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APPENDIX 7.—GUIDANCE ON DOCUMENTATION

[COMMITTEE NOTE.—This information is taken from GAO's report entitled "Financial Integrity Act: The Government Faces Serious Internal Control and Accounting System Problems." GAO/AFMD-86-14, December 1985.]

Documentation of system evaluations should be a tool to assist in developing meaningful corrective actions and planning future work. The purpose of documenting a system evaluation should be to provide managers with useful information such as a record of the work performed, those who performed it, and the conclusions reached. Our advice in determining "how much documentation is enough" is that the amount and depth of documentation should be sufficient so that management can determine the basis for the conclusions reached and be able to build on the work in the future.

It is also important to keep in mind the difference between documenting the system evaluation and the system itself. Systems should be documented as they are designed and implemented and updated as design changes are made. * * *

System documentation tells management how its internal control and accounting systems are designed to operate. Without this information, it is difficult, if not impossible, to diagnose and correct system breakdowns, particularly in an automated system. In addition, planning or system changes becomes more difficult.

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APPENDIX 8.—DOCUMENTATION CHECKLIST

[COMMITTEE NOTE.—This checklist is adapted from the Department of Health and Human Services' training manual in internal controls entitled "Internal Control Review Guide," February 1986.]

Who are the persons who conducted the tests listed?
Who are the persons who were observed listed?
Who are the persons who were interviewed listed?
What is the rationale or reason for your test design described?
Is there a description of what items were viewed?
Is there a description of what information was collected during the interviews?
Is there a description of the informal controls used to compensate for nonexistent or weak controls?
Is there a description of the test results?
When is the testing schedule included in the file?
Where are the testing locations included in the file?
Document evidence:
    Are copies of documents or other physical evidence retained in the file?
    If not, is there a list indicating the location of the supporting documents?

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APPENDIX 9.—DOCUMENTING TEST RESULTS

This illustrative chart can be found in training materials prepared by the Department of Health and Human Services.

EXAMPLE: DOCUMENTING THE TEST RESULTS

INTERNAL CONTROL AREA: Procurement

EVENT CYCLES: Award

CONTROL TECHNIQUE	IS CONTROL FUNCTIONING? Yes/No	IS CONTROL ADEQUATE? Yes/No	COMMENTS/ RECOMMENDATIONS
1.1 The procedures used for receipt of proposals are posted for all office workers' reference.	Yes	Yes	100% compliance found in testing
1.2 The time and date of the proposal's submission is stamped onto the proposal.	Yes	Yes	100% compliance found in testing
1.3 All proposals received are logged in and then locked in the office safe.	No	Yes	Observation found proposals not always locked in safe
1.4 Proposal receipt logs are spot-checked by supervisors.	Yes	No	Spot checks of logs should be replaced by supervisor observation

1 According to test results, are control techniques functioning?

2 Do test results show control techniques to be adequate?

3 Comment on Findings

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